

TAX TREATIES-AN OVERVIEW

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Workshop on Basics of International Taxation

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SYNOPSIS

- ✧ **International Taxation- An Introduction**
- ✧ **Tax Treaties-An Introduction.**
- ✧ **Tax Treaty Structure**
- ✧ **Discussion of prominent Articles of a Tax Treaty**
- ✧ **Some important concepts**

INTERNATIONAL TAXATION AN INTRODUCTION

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3

GLOBALIZATION

What is Globalization ?

Globalization is the phenomenon of

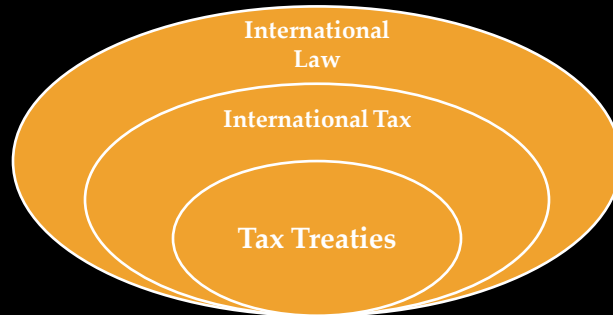
- × Sourcing capital from where it is cheapest,
- × Sourcing people from where it is best available,
- × Producing where it is most cost effective and
- × Selling where the markets are.

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4

INTERNATIONAL TAXATION- MEANING

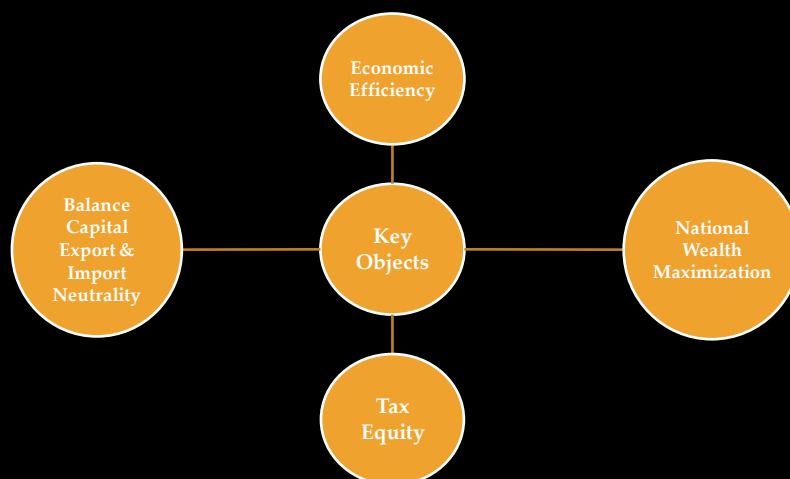
It is a body of legal provisions embedded in the tax laws of each country to cover the tax aspects of cross border transactions.



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INTERNATIONAL TAXATION-OBJECTIVES



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TAX TREATIES

AN INTRODUCTION

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TAX TREATY

- ✕ Meaning-A tax treaty is a formally concluded and ratified agreement between two independent nations (bilateral treaty) or more than two nations (multilateral treaty) on matters concerning taxation

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OBJECTIVES



TAX TREATIES- EVOLUTIONARY MILESTONES

| | |
|------|---|
| 1899 | •The first DTAA entered in to between Prussia & Austria |
| 1928 | •The first model draft DTAA was published with the concept of PE being introduced for the first time |
| 1943 | •The Mexico Model was released |
| 1946 | •The London Model convention was released |
| 1956 | •The OEEC took upon the task of improving the model DTA to suit the needs of its member countries |
| 1961 | •OEEC was superseded by OECD |
| 1963 | •The first draft of OECD model was published |
| 1977 | •The final version of the OECD Model was published & has been last revised in 2008 |
| 1979 | •Developing countries take recourse to UN model as OECD model is biased towards Developed nations (Last Update in 2001) |
| 1981 | •US model is introduced. Last revised in 2006 |

MODEL CONVENTIONS

Model conventions-

- ✖ provide the broad framework for treaty formulation
- ✖ serve as useful interpretation material

The popular model conventions are:

- a) UN Model
- b) OECD Model
- c) US Model

TYPES OF TAX TREATIES

- ✖ Limited Treaties-which cover -
 - a) income from operation of aircrafts and ships,
 - b) estates,
 - c) inheritance and
 - d) gifts.
- ✖ Comprehensive Treaties-which are wider in scope addressing all sources of income

TREATY POSITION IN INDIA

- ✦ Section 90(1) of the Indian Income Tax Act, 1961 authorizes the Central Government to conclude tax treaties
- ✦ India presently has treaties with 91 countries
- ✦ Section 90 (2) of Income Tax Act Vs. Section 258(8) of the Direct Tax Code
- ✦ Section 91 - provides unilateral relief

TAX TREATY STRUCTURE

ARTICLES- CLASSIFICATION

| Application Articles | Definition Provisions | Anti-Avoidance Provisions | Elimination of Double Taxation | Miscellaneous Provisions |
|---|--|--|---|--|
| <ul style="list-style-type: none"> • Article 1- Applicability • Article 2- Taxes Covered • Article 30- Entry into Force • Article 31- Termination | <ul style="list-style-type: none"> • Article 3- General Definitions • Article 4- Residence • Article 5- Permanent Establishment | <ul style="list-style-type: none"> • Article 9- Associated Enterprises • Article 26- Exchange of Information • Article 27- Assistance for collection of tax | <ul style="list-style-type: none"> • Article 23- Elimination of Double Tax | <ul style="list-style-type: none"> • Article 24- Non-Discrimination • Article 28- Diplomats • Article 25- Mutual Agreement • Article 29- Territorial extension |

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DISTRIBUTIVE ARTICLES

- ✖ Article 6-Immovable Property
- ✖ Article 7-Business Profits
- ✖ Article 8-Shipping, etc.
- ✖ Article 10-Dividends
- ✖ Article 11-Interest
- ✖ Article 12-Royalties & Fees for Technical Services
- ✖ Article 13-Capital Gains
- ✖ Article 14-Independent Personal Services
- ✖ Article 15-Dependent Personal Services
- ✖ Article 16-Directors
- ✖ Article 17-Artistes & Sports persons
- ✖ Article 18-Pensions
- ✖ Article 19-Government Services
- ✖ Article 20-Students
- ✖ Article 21-Other Income
- ✖ Article 22-Capital

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PROMINENT ARTICLES -A DISCUSSION

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SCOPE

Article 1- Applicability -Applies to a person who is a resident of one or both the countries.

Article 2- Taxes covered- Taxes on income and capital

✱ Indian taxes covered are income tax, surcharge and cess

Article 30-Entry into force

This article tells when and how a DTA becomes operative

Article 31-Termination

This article tells when and how a DTA can be terminated

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18

DEFINITIONS

✧ Article 3-General Definitions

1. Person
2. Company
3. Contracting State
4. Enterprise of a Contracting State
4. Competent Authority
6. National

Undefined Terms-meaning to be as defined under the domestic tax laws applicable to the taxes covered in the treaty

DEFINITIONS

Article 4 - Residence

A person is a resident of a country if he is liable to tax in the country by virtue of:

- Domicile
- Residence
- Place of Incorporation
- Place of management
- Any other criterion of a similar nature

✧ Tie-Breaker Rules- In the case of a dual resident, the tie-breaker rules shall apply to determine the residential status

- a) In the case of an individual his personal and economic ties determine his residential status
- b) In the case of others it is the place of effective management

DEFINITIONS

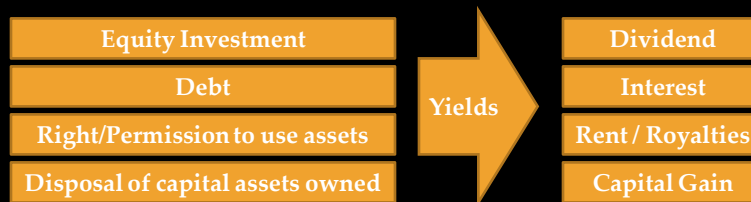
Article 5 - Permanent Establishment (PE)

- ✦ Means a fixed place from where the business of the enterprise is carried on
- ✦ PE includes place of management, branch, office, factory, workshop, mine, quarry, an oil or gas well, a construction site for long duration, a services location for long duration and a dependent agency with power to conclude contracts

DISTRIBUTIVE PROVISIONS

ACTIVE & PASSIVE INCOME

- ✖ **Passive Income**-refers to income derived from investment in tangible / intangible assets.



- ✖ **Active Income** is the income derived from carrying on active cross border business operations or by personal effort and exertion as in case of employment.

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PASSIVE INCOMES-DISTRIBUTION OF TAXING RIGHTS

| Article Ref. | Nature of Income | Taxing Right of Source State | Taxing Right of State of Residence | Remarks |
|--------------|---|--|------------------------------------|--|
| 6 | Income from Immovable Property | Has the first right to tax | Reserves the right to tax | |
| 10 | Dividend Income | Has the right to tax provided rate does not exceed the agreed rate of tax as per DTAA | | Dividend is not taxable in India. DDT is levied upon the company declaring dividends |
| 11 | Interest Income | | | |
| 12 | Royalties and Fees for Technical Services | | | |
| 13 | Capital Gains | Has the first right to tax a | | Tax can be determined as per the domestic law |
| 18 | Pensions | Cannot tax pension | Can tax Pension | |

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24

ACTIVE INCOMES-DISTRIBUTION OF TAXING RIGHTS

| Article Ref. | Nature of Income | Taxing Right of Source State | Taxing Right of State of Residence | Remarks |
|--------------|--|---|------------------------------------|---|
| 7 | Business Profits | Yes, if PE exists in the source state | Reserves the right to tax | Income attributable to PE alone can be taxed in source state |
| 8 | Shipping & Air Transport | Cannot tax this income | | |
| 14 | Independent Personal Services | Yes, if the person has a fixed base or his stay extends beyond 90 days | | Income attributable to Fixed Base alone can be taxed in source state |
| 15 | Dependent Personal Services (Employment) | Yes, if employment is exercised in the source state. Cannot tax if stay is less than 183 days | | If salary is paid on behalf of foreign employer and is not borne by PE, then source state cannot tax the salary |

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25

ACTIVE INCOMES-DISTRIBUTION OF TAXING RIGHTS

| Article Ref. | Nature of Income | Taxing Right of Source State | Taxing Right of State of Residence | Remarks |
|--------------|----------------------------|--|------------------------------------|--|
| 16 | Directors' Fees | Yes, the source state can tax the same | Reserves the right to tax | |
| 17 | Artiste & Athletes | Yes, the source state can tax the same | | DTA may specify the extent to which the income may be exempt |
| 19 | Govt. Service Remuneration | No, unless the person rendering service happens to be a resident of and national of the source state | | |
| 20 | Students & Apprentices | No taxing rights | | |
| 21 | Other Income | Yes, the source state can tax the same | | |

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26

ANTI-AVOIDANCE PROVISIONS

| Article Ref. | Title | Comments |
|--------------|-----------------------------------|---|
| 9 | Associated Enterprises | Adoption of <u>Arms Length Price</u> in transactions between Associated Enterprises |
| 26 | Exchange of Information | |
| 27 | Assistance in collection of taxes | Both the contracting states shall assist each other in collection of revenue claims |

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ELIMINATION OF DOUBLE TAXATION

Juridical Double Taxation and Economic Double Taxation

Article 23 –Alternate methods are as below:

- ✦ The Exemption Method
 - Full Exemption
 - Exemption with progression
- ✦ Foreign Tax Credit Method
 - Full Credit
 - Ordinary Credit
- ✦ Deduction Method

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28

MISCELLANEOUS PROVISIONS

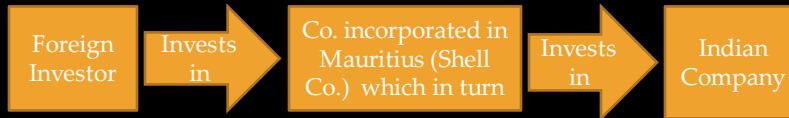
| Article Ref. | Title |
|--------------|----------------------------|
| 24 | Non-Discrimination |
| 25 | Mutual Agreement Procedure |
| 28 | Diplomats |
| 29 | Territorial Extension |

INTERPRETATION OF TREATY

- ✧ Tax Treaty Vs. Domestic Law
- ✧ The Vienna Convention on Law of Treaties, 1969 (VCLT) has codified international law. The rules contained in it can be applied to interpret treaties.
- ✧ Section 31(1) to 31(4) of the VCLT, 1969 lays down the foundation for interpretation as per customary international laws
- ✧ Section 31(1) states that a DTA shall be interpreted in GOOD FAITH in accordance with the ORDINARY MEANING to be given to the terms of the treaty in their CONTEXT and in the light of its object.
- ✧ Treaties are based either on UN or OECD model. Hence commentaries in these models may assist interpretation

SOME IMPORTANT CONCEPTS

✕ Treaty Shopping



✕ Most Favored Nation (MFN) Clause

✕ Protocols

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31

APPLYING TAX TREATIES

- Step 1 What is the nature of the income ?
- Step 2 Does the treaty apply?
- Step 3 Determine which Article applies?
- Step 4 How are taxation rights assigned?
- Step 5 How is the income calculated?

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32

REFERENCE MATERIAL

International Tax Policy and Double Tax
Treaties by Kevin Holmes

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33

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34